



# *Policy Note*

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## THE FUTURE OF THE DOLLAR

### Has the Unthinkable Become Thinkable?

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The big question is whether the dollar—the world’s reserve currency—can survive a steep fall in its value without the active support of the major central banks. Can the United States broker another Plaza Accord, as it did in 1985 when the dollar lost half of its value against the yen and the mark within two years, without jeopardizing its unique international role? Is an orderly retreat for the dollar possible today?

**The recent stock market bubble** led to overinvestment, especially in the high-technology sector. Now that the bubble has burst, there is overcapacity in this sector and throughout the economy. Underutilized capacity, combined with a high level of indebtedness in the U.S. corporate sector, implies that business investment will be depressed for a long time to come. Despite falling stock prices and contraction of business investment, a consumption boom has continued, kept alive by a bond market bubble underwriting a housing boom, along with a high dose of fiscal stimulus. The administration of George W. Bush hopes that the consumption boom can be kept alive until corporate balance sheets improve and business investment picks up. In the meantime, the aggregate macroeconomic imbalances have been getting worse (Godley 2003, Shaikh et al 2003a, and Godley and Izurieta 2002). The household sector remains in deficit and its debt-to-income ratio is at an all-time high (Papadimitriou et al 2002). The budget deficit is expected to

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exceed \$400 billion this year, and the current account deficit is already in excess of 5 percent of GDP. Now that foreigners own more assets in the United States than Americans own in the rest of the world, U.S. net investment income—interest plus dividend payments—has turned negative and will fall further when interest rates go back up again.

The weak economic recovery and the ballooning current account deficit stoke expectations that the United States will eventually revert to a weak-dollar policy, the only untried demand stimulus that may keep the current economic recovery from running out of steam. The idea is that a weak dollar will increase exports and improve the trade deficit.

Given that world demand is stagnant, a significant increase in U.S. exports would probably require a substantial fall in the value of the dollar (Shaikh et al 2003b). By exporting deflation to the rest of the world, a weak dollar would allow the U.S. economy to expand at the expense of the Asian and European economies. A weak dollar would also make more difficult the maintenance of the private consumption boom in the United States, however. A gradual weakening of the dollar would be particularly harmful, since it would dampen the attractiveness of U.S. assets—stocks as well as bonds—for foreign buyers. If foreign investment slackened, then U.S. interest rates would rise sharply. Given the high level of household debt, the negative impact of high interest rates on private consumption could be greater than the positive impact of a lower dollar on exports.

A sharp and steep dollar devaluation, rather than a slow downward drift, is preferable for the United States: it would wipe out the asset devaluation risk in one fell swoop and make U.S. assets cheap and attractive to foreign buyers once again. Furthermore, foreign currency-denominated assets owned by Americans overseas and the investment income that these assets generate would rise in value (in dollar terms), while dollar-denominated U.S. liabilities to foreigners would remain unchanged. The U.S. economy would benefit from a substantial improvement in its negative net investment with the rest of the world, while countries such as China, with a large stock of dollar-denominated assets, would lose out.

### **The Big Question**

The big question, of course, is whether the dollar—the world's reserve currency—can survive a steep fall in its value without the active support of the major central banks. Can the United

States broker another Plaza Accord, as it did in 1985 when the dollar lost half of its value against the yen and the mark within two years, without jeopardizing its unique international role? Is an orderly retreat for the dollar possible today?

This time around, getting the rest of the world to adjust their economies to suit the needs of the United States is likely to be more difficult. The irony is that as long as export-led growth is the name of the game and the United States remains the engine of world growth and the importer of last resort, no one wants the dollar to lose its value significantly. The Europeans and especially the Japanese have been trying hard to keep the value of the dollar from falling any further against their currencies. In the meantime, China has been resisting international pressures to revalue the renminbi. In fact, partly because of the huge dollar positions around the globe, any move toward another currency appears to be self-limiting under present conditions, as long as exports remain the engine of growth in the rest of the world. Any country whose currency appreciates against the dollar is liable to experience falling exports and economic stagnation, which would curtail the demand for its currency.

### **The Current Impasse**

The current impasse stems ultimately from the growing inability of the United States to continue to be the source of global demand. Although much of the rest of the world may still hope that the United States will continue to be the importer of last resort and regain its position as the engine of world growth, those roles appear increasingly untenable. As argued earlier, a steep fall in the value of the dollar could revive U.S. growth, but only if U.S. interest rates remain at a low level. Keeping interest rates low as the dollar depreciates, in turn, requires the joint intervention of the major central banks in the foreign exchange markets. Foreign investment in the United States must continue unabated as the dollar falls in value, in the likely event that U.S. assets lose much of their attractiveness for foreign private investors. However, even if the foreign central banks cooperate, a growing U.S. economy with a substantially weaker dollar would hardly be a source of increasing demand for the rest of the world. That is why another Plaza Accord, which allowed an orderly retreat for the dollar, appears unlikely. Moreover, the division among the major industrial powers that was created by the Iraq war may come back to

haunt the Bush administration as it learns that international good will is an asset when exerting leadership. Thus, it is likely that all major foreign players will continue to resist currency revaluations against the dollar, at least for the time being.

But then, something has to give. The current value of the dollar is predicated on the assumption that the U.S. economy will continue to act as the engine of world growth. As doubts mount about a U.S. economic recovery, faith in the dollar will rapidly erode around the world, and that erosion could turn into a rout.

### **Could There Be a Run on the Dollar?**

Even though no one wants it to fall in value, there could still be a run on the dollar. The form of the run, if it happened, would be quite different from traditional currency crises, such as the collapse of the Bretton Woods system (which occurred in slow motion, compared to today's digital age) or the Latin American crises of the 1980s. Most economists agree that these episodes were triggered by reserve depletion caused by a monetized spending hike.

Admittedly, the current combination of easy money and ballooning twin deficits (current account and government) at a time of escalating military engagement is reminiscent of the Vietnam era. Today's easy money and lax U.S. fiscal policy are helping to keep the dollar afloat, however, by providing hope that a U.S. economic recovery is alive. Without a fiscal stimulus and a bond market bubble engineered by the Fed, a sharp contraction in demand would probably have resulted in a severe recession and would have triggered a financial meltdown. In our digital age, a currency attack can result simply from speculators expecting a steep dollar devaluation to be inevitable, and this expectation is gaining strength in the world financial markets. The longer U.S. economic growth takes to revive, the stronger will be the voices of alarm about the size of the U.S. current account deficit. If a run on the dollar occurs, the excuse will be the current account deficit, but the real cause will be the failure to revive economic growth. (This is not to suggest, of course, that the size of the deficit is unimportant.)

In the meantime, the financial markets' gradual loss of faith in the dollar will continue to stoke deflation in the rest of the world, as long as new sources of demand fail to emerge. Consider the much-talked-about liquidity trap in Japan. By definition, a liquidity trap occurs when an increasing number

of agents in the financial markets believe in the high probability of a steep fall in asset prices. In Japan, the demand for stocks was stagnant until very recently, as the financial markets felt that equity prices were artificially kept from hitting bottom. Injections of liquidity in Japan did not, as one would have expected, translate into increased demand for the more lucrative U.S. assets either, indicating the high perceived risk of dollar devaluation. As a result, U.S. assets remained unattractive because the yen was expected to increase in value against the dollar, while the same expectation made Japanese assets unattractive: investors believed that a strong yen would suppress corporate profits by lowering exports. Thus, remaining liquid in yen continued to be the preferred option and, hence, the liquidity trap prevailed.

The same dilemma exists for Europe. As confidence in the dollar ebbs, the euro gains in relative value and that response, in turn, decreases profit expectations of corporations in Europe and puts downward pressure on equity prices there. Moreover, European companies are threatened by the stiffer competition from Asian exports in Europe. Thus, as stated earlier, any move toward another major currency appears to be self-limiting under current conditions.

### **A New Engine of Growth?**

In spite of the increasing doubts about the ability of the U.S. economy to act as the engine of world growth, it remains the only game in the global town. To speculate on the dollar's demise if a credible alternative source of global demand had emerged to replace the United States is not far off the mark. But no alternative is in sight. Leading up to the war in Iraq, the shock of U.S. military aggression seemed ready to sow the seeds of a formidable Eurasian block and create an alternative by bringing together Europe with its viable new currency (the euro), a nation with nuclear capability and oil (Russia), and a kingmaker (China). Although the Bush administration appeared reckless enough to push all three powers into an alliance against itself prior to the Iraq war, the current fiasco in Iraq has resulted in a toned-down neoconservative rhetoric and a slowed momentum in favor of the emergence of a Eurasian block—barring, at least, new adventures on the part of the U.S. government.

Without the forces generated by extraordinary circumstances, it is difficult to believe that Europeans, with their fractured political system, could seize the moment on their

own. Japan's heavy military dependence on the United States and perennial fear of China militates against a more global role for the yen. Likewise, China, the potential kingmaker with a massive dollar stock in the event that the dollar is challenged by another currency, has every reason to fear a revaluation of the renminbi, which could slow its export engine and collapse its exceedingly fragile banking system.

Yet, one also has to be aware that the political equation could change quite rapidly and in unexpected ways if the economies of the major players seriously worsened. The pressure to reflate could become too strong to be brushed off by politicians, no matter what defunct economic theory might enslave them, as exemplified by the current tensions within the European Economic and Monetary Union.

### Then What?

If neither an orderly retreat of the dollar nor the emergence of a new source of global demand to replace the U.S. economy is likely, then what? While there is no telling how bad the bad scenario can get, the rosy scenario that the U.S. policymakers are betting on involves a race against time. The Fed is trying to prevent the bond market bubble from bursting, which would depress the real estate market and the private consumption boom, before the business outlook improves in the corporate sector. It hopes that, once investment comes back to life, the economy will then easily grow out of its budget deficit, and the current account deficit, whatever its size, will be equity financed by foreigners and cease to be a problem. But, how the Fed can manage a soft landing in the bond and the real estate markets as growth revives, without triggering a sharp reversal in private consumption, is anyone's guess. Call it wishful thinking, but it is this rosy scenario that seems to be holding together the pieces in financial markets today.

As confidence in the rosy scenario subsides around the world, the likely outcome is a gradual fragmentation of the world currency markets: the dollar and other major currencies will cease to be the magnets they have been during the era of financial liberalization. While this outcome makes the U.S. economy increasingly vulnerable, it may prove to be beneficial for developing countries by making it easier for them to stimulate their own internal demand. Many of the soft currencies, such as the Indian rupee and the Turkish lira, are already showing an amazing degree of resilience. This welcome respite from

foreign exchange constraints is happening not only because hot money is returning, as expected, to the emerging markets, but also because people with wealth are buying assets denominated in local currencies. The greater the expectation of a weak dollar and the greater the uncertainty about the euro and the yen, the greater the ability of developing countries to reflate their economies. This may also prove to be an opportune time to experiment in setting up regional networks and to rehash ideas such as the Asian Monetary Fund, which was shot down by the United States and the International Monetary Fund after the Asian crisis—especially if the newfound assertiveness of the southern hemisphere at the last ministerial meeting of the World Trade Organization in Cancun proves to be some sign of a sea change in the developing world.

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